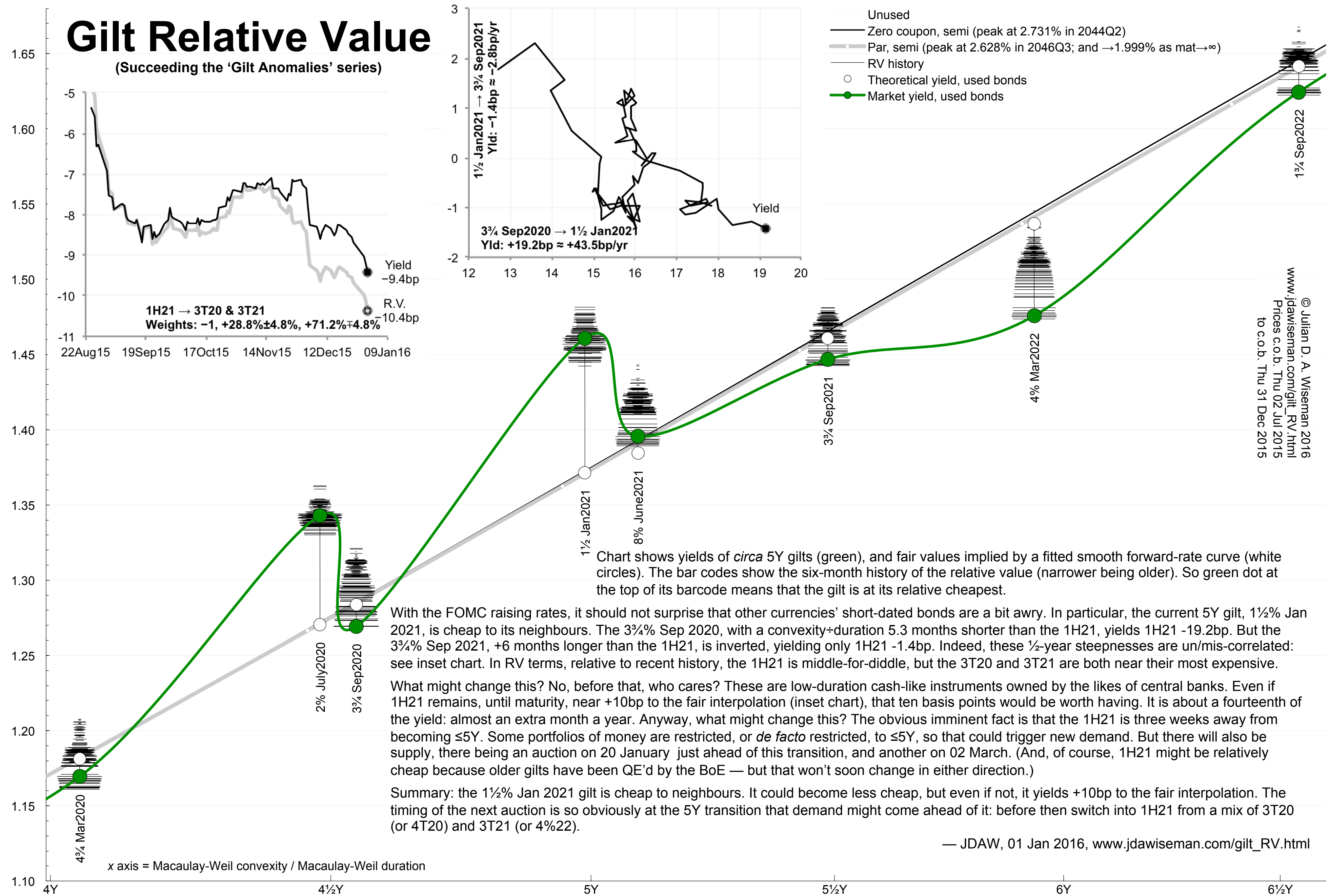
Gilt Relative Value

(Succeeding the 'Gilt Anomalies' series)



www.jdawiseman.com/gilt_RV.html
Prices c.o.b. Thu 02 Jul 2015
to c.o.b. Thu 31 Dec 2015

Chart shows yields of *circa* 5Y gilts (green), and fair values implied by a fitted smooth forward-rate curve (white circles). The bar codes show the six-month history of the relative value (narrower being older). So green dot at the top of its barcode means that the gilt is at its relative cheapest.

With the FOMC raising rates, it should not surprise that other currencies' short-dated bonds are a bit awry. In particular, the current 5Y gilt, 1½% Jan 2021, is cheap to its neighbours. The 3¾% Sep 2020, with a convexity÷duration 5.3 months shorter than the 1H21, yields 1H21 -19.2bp. But the 3¾% Sep 2021, +6 months longer than the 1H21, is inverted, yielding only 1H21 -1.4bp. Indeed, these ½-year steepnesses are un/mis-correlated: see inset chart. In RV terms, relative to recent history, the 1H21 is middle-for-diddle, but the 3T20 and 3T21 are both near their most expensive.

What might change this? No, before that, who cares? These are low-duration cash-like instruments owned by the likes of central banks. Even if 1H21 remains, until maturity, near +10bp to the fair interpolation (inset chart), that ten basis points would be worth having. It is about a fourteenth of the yield: almost an extra month a year. Anyway, what might change this? The obvious imminent fact is that the 1H21 is three weeks away from becoming ≤5Y. Some portfolios of money are restricted, or *de facto* restricted, to ≤5Y, so that could trigger new demand. But there will also be supply, there being an auction on 20 January just ahead of this transition, and another on 02 March. (And, of course, 1H21 might be relatively cheap because older gilts have been QE'd by the BoE — but that won't soon change in either direction.)

Summary: the 1½% Jan 2021 gilt is cheap to neighbours. It could become less cheap, but even if not, it yields +10bp to the fair interpolation. The timing of the next auction is so obviously at the 5Y transition that demand might come ahead of it: before then switch into 1H21 from a mix of 3T20 (or 4T20) and 3T21 (or 4%22).

— JDAW, 01 Jan 2016, www.jdawiseman.com/gilt_RV.html